

***United States Court of Appeals
for the
District of Columbia Circuit***



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DISTRICT OF COLUMBIA
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IN THE

Court of Appeals, District of Columbia.

OCTOBER TERM, 1915.

No. 2898.

291

DISTRICT OF COLUMBIA, A MUNICIPAL CORPORATION,
APPELLANT,

vs.

WASHINGTON GAS LIGHT COMPANY, A CORPORATION.

BRIEF FOR APPELLANT.

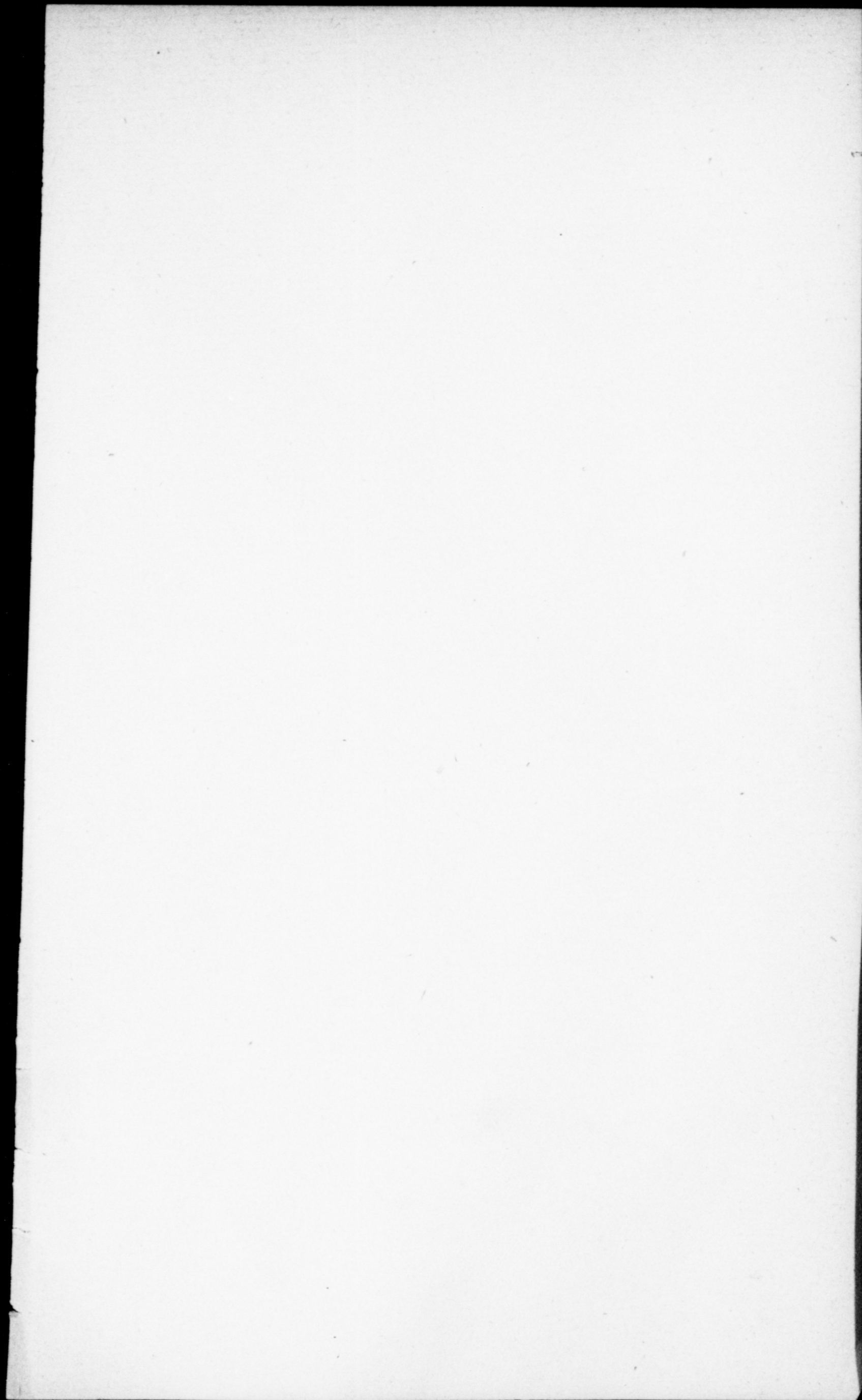
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vs.

WASHINGTON GAS LIGHT COMPANY, A CORPORATION.

BRIEF FOR APPELLANT.

Statement of the Case.

This is an appeal from a judgment of the Supreme Court of the District of Columbia awarding judgment in favor of the Washington Gas Light Company in the sum of \$31,321.62, with interest from June 15, 1914, illegally exacted from the company as part of a personal tax under the act of July 1, 1902, which imposes a tax upon gas companies of five per cent on the gross earnings.

For the year ending June 30, 1913, the company, on July 16, 1913, made a return to the assessors of the District

of Columbia of its gross earnings in the sum of \$1,496,550.97. On June 13, 1914, at the request of the assessors, the company made a further return of \$57,629.43, making a total return of \$1,554,180.40 as its gross earnings from all sources (R., p. 2). The assessors increased this amount by \$604,842.20, making a total assessment of \$2,159,022.60. The increased amount was the cost of raw material used by the company in the manufacture of gas, and claimed by it to be not a part of its gross earnings and not subject to taxation (R., p. 3). The company tendered the tax upon \$1,554,180.40, which tender was refused (R., p. 4) and a penalty of one per cent was added to the tax upon the failure of the company to pay the whole tax when due. The penalty was \$1,079.51, and the amount of the tax upon the cost of raw materials was \$30,242.11, a total of \$31,321.62, which the company paid under protest.

An amended declaration was filed, substantially like the original, differing in the statement found on page 3 of the record:

“The plaintiff says the said sum of \$604,842.20, money so spent for the said raw materials purchased as aforesaid, was money taken from its capital, which capital was composed in part of such part of its earnings theretofore added to its capital as remained to it after providing for the payment of all charges and expenses including real and personal taxes for and during the year in which said earnings had accrued, and of dividends on its capital stock.”

A demurrer was filed to the declaration, which the court overruled. The defendant elected to stand on its demurrer, and judgment was accordingly entered for the plaintiff in the sum of \$31,321.62, with interest from June 15, 1914, from which defendant appealed.

There is no statement in the declaration of what composed the “raw materials” used by the plaintiff in the manufacture of gas, but the argument below proceeded upon the supposition that they consisted of oil, coal, and water.

ARGUMENT.

Under paragraph 5 of section 6 of the act of July 1, 1902 (32 Stat., 617)—

"All gas * * * companies, through their proper officers, shall make affidavit to the board of personal-tax appraisers on or before the first day of August each year, as to the amount of its * * * gross earnings for the preceding year ending the thirtieth day of June, and shall pay to the collector of taxes of the District of Columbia per annum on such gross earnings as follows: * * * each gas company, five per centum,"

the question arises:

Are the "gross earnings" of the company the total amount it receives from the sale of gas, or is it the total amount less the cost of raw materials?

If the cost of material should be deducted, why not the cost of labor? Why not, also, the cost of appliances necessarily used in manufacture? Material, labor, and machinery are essential, and equally essential, to produce a manufactured article. An almost infinite variety of things are produced through the agency of these three essentials. The absence of any one would result in a failure to produce. Yet if the cost of these be deducted from the moneys derived from the sale of the finished article, the remainder is net earnings, not gross. It will probably be conceded that the deduction of either material or labor would be a step toward the ascertainment of net earnings. Why raw materials should be regarded as of more importance than either labor or appliances is not explained.

Supreme Court Cases.

The Supreme Court of the United States has had occasion, in a number of cases, to consider what is meant by earnings, gross earnings, and net earnings, and a careful study of these cases is very important in determining what is meant by the term "gross earnings" in the act of 1902, now under consideration.

In *Union Pacific Railroad Company vs. United States*, 99 U. S., 402, the question was what were the "net earnings" of the company: The statute provided that—

"After said road is completed, until said bonds and interest are paid, at least five per cent of the net earnings of said road shall also be annually applied to the payment thereof,"

that is, to the payment of the Government loan. The court said:

"II. The question next arising is, What are the 'net earnings' for five per cent of which the company became liable to account, and in what manner are they payable?

"In the first place, they are the 'net earnings of the road'; that is, the net earnings of the road as a railroad, including the telegraph. They have nothing to do with the income or profits of the company as a holder of public lands. The proceeds of this source of income are no part of the earnings of the road. These earnings, however, must be regarded as embracing all the earnings and income derived by the company from the railroad proper, and all the appendages and appurtenances thereof, including its ferry and bridge at Omaha, its cars and all its property and apparatus legitimately connected with the railroad.

"In the present case, but little difficulty is presented in determining what are the proper earnings of the road, except in one particular. The company insists that the compensation accruing to it for services per-

formed for the Government, under the sixth section of the act of 1862, should not be estimated among the earnings of the road, in taking an account of net earnings upon which to calculate the five per cent in question. That compensation is not receivable by the company,—does not come into its hands,—at least was not receivable by it according to the act of 1862, but was directed by the sixth section to be applied to the payment of subsidy bonds. After giving this direction, the section proceeds to add, that after the road is completed, ‘until said bonds and interest are paid, five per centum of the net earnings of said road shall also be annually applied to the payment thereof.’ It is contended that the net earnings here referred to are intended to be exclusive of said compensation for Government service, no part of which the company was to receive. It must be admitted that there is some force in this view. But the majority of the court is of opinion that the plain letter of the statute cannot be thus varied by construction. The compensation accruing by means of services performed for the Government is unquestionably earnings of the road and telegraph; and as there are no words in the act which go to show any intention to except this portion of earnings from the other earnings of the road in estimating the amount of net earnings, the conclusion arrived at is, that no such exception can be made. The fact that by a subsequent law the company is allowed to receive in money one-half of the compensation referred to, removes to a great extent the practical difficulties that have been suggested in this behalf.”

* * * * *

“Having considered the question of receipts or earnings, the next thing in order is the expenditures which are properly chargeable against the *gross earnings* in order to arrive at the ‘net earnings,’ as this expression is to be understood within the meaning of the act. As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves. It may often be

difficult to draw a precise line between expenditures for construction, and the ordinary expenses incident to operating and maintaining the road and works of a railroad company. Theoretically, the expenses chargeable to *earnings* include the general expenses of keeping up the organization, and all expenses incurred in operating the works and keeping them in good condition and repair; whilst expenses chargeable to *capital* include those which are incurred in the original construction of the works, and in the subsequent enlargement and improvement thereof. With regard to the last-mentioned class of expenditures, however, namely, those which are incurred in enlarging and improving the works, a difference of practice prevails amongst railroad companies. Some charge to construction account every item of expense, and every part and portion of every item, which goes to make the road, or any of its appurtenances or equipments, better than they were before; whilst others charge to ordinary expense account, and against earnings, whatever is taken for these purposes from the earnings and is not raised *upon bonds or issues of stock*. The latter method is deemed the most conservative and beneficial for the company, and operates as a restraint against injudicious dividends and the accumulation of a heavy indebtedness. The temptation is, to make expenses appear as small as possible so as to have a large apparent surplus to divide. But it is not regarded as the wisest and most prudent method. The question is one of policy, which is usually left to the discretion of the directors."

* * * * *

"We are disposed to agree, therefore, with the judge who delivered the concurring opinion in the court below, that the twenty-seventh item of expenditure, as stated in the table of expenses, in the eighteenth finding, 'expenditures for station buildings, shops, etc.,' is a charge that may properly be made against *earnings*, since, as the fact is, such expenditures were actually paid therefrom, and were not carried to capital account."

* * * * *

"We agree with the Court of Claims in its rejection of the expenditures contained in items seventeen to thirty in the table referred to, excepting item twenty-seven. All payments of interest on the bonded indebtedness of the company should be charged to capital interest account, and not to current expenditures. Though payable out of earnings before any dividend can be made to stockholders, they cannot be deducted for the purpose of ascertaining the 'net earnings' of the road, as that term is to be understood in the sixth section of the act. The bonded debt incurred for the purpose of construction and equipment is but another form of capital, analogous to preferred stock; and the interest accruing thereon is in the nature of a dividend on such capital. It has nothing to do with, and cannot affect, the amount of the net earnings of the road.

"So the expenses of land and town-lot departments, and taxes on lands and town lots, are expenses properly belonging to the land department of the company's property. They are entirely distinct from its expenses as a railroad company; and form no proper charge in the account, against the earnings of the road."

* * * * *

"It is found by the Court of Claims that the Union Pacific Railroad Company did issue its first mortgage bonds as authorized by this section, and to the full amount allowed thereby. The company contends that the interest on these bonds, if not its other interest, should be charged as an expenditure against the earnings of the road, in taking an account of its net earnings, which would reduce the net earnings of each year by the amount of said interest. We have already expressed an opinion that this claim cannot be sustained. The interest on these bonds do not, any more than the interest on the bonds of any other company, form any proper portion of the expenditures of the road to be considered in estimating the net earnings mentioned in section 6 of the act of 1862."

In *United States vs. Kansas Pacific Railway Company*, 99 U. S., 455-459, the same question was before the court and

certain items were examined as to the propriety of the road's action in deducting them before arriving at the net earnings out of which the five per cent due the Government should be paid. The court said:

"The former insists that certain items should be excluded from the account which are claimed by the latter to be legitimate. These items are designated in Schedule C, annexed to the findings of the court below, and are as follows:

"First. 'Depreciation account, or expense, not charged up.' This is explained to be the amount necessary to put the road in proper repair, but which was not actually expended for that purpose. We are clearly of opinion that it is not a proper charge. Only such expenditures as are actually made can with any propriety be claimed as a deduction from earnings.

"Secondly. 'Construction account, or improvements and additions to track,' etc. This item, according to what we have said in the Union Pacific Railroad case, ought to be allowed.

"Thirdly. 'Equipment accounts, or replacing and rebuilding rolling-stock, machinery,' etc. This item should also be allowed as an expenditure properly chargeable to the earnings of the road, when actually paid out of the earnings and not raised by the issue of bonds or stocks.

"Fourthly. 'Real estate purchased for depot ground, etc., and expenses of same.' This item is a proper charge if actually paid out of the earnings, and not raised by bonds or stock.

"Fifthly. 'Expenses of land department.' This item is not allowable.

"Sixthly. 'Interest on funded debt prior to public lien.' For the reasons expressed in the case of the Union Pacific Railroad Company, this item is not allowable, though the interest annually accruing on the first mortgage bonds issued upon the first 393 15/16 miles of the road is payable out of the net earnings before the five per cent due the Government.

"Seventhly. 'Fifty per cent Government earnings withheld.' This, as explained in the previous opinion, is not allowable to be charged as an expense."

In *Spreckels Sugar Refining Company vs. McClain*, 192 U. S., 397, the court examined the question of what constituted "gross annual receipts" in the business of sugar refining. The controversy arose over the wharfage derived from three wharves owned by the company. Nearly all the raw sugar came to these wharves in vessels which paid for the wharfage (p. 414). After deciding that the wharves were a part of the company's "plant" (p. 415), the court held the fees paid were part of the gross receipts, but excluded interest on bank deposits and dividends on stock in other companies.

It is evident that here the gross receipts and the gross earnings were the same.

In *Grant vs. H. & N. H. R. R.*, 93 U. S., 225, the discussion was over "profits used in construction," which were taxed (pp. 227-8):

"Mr. Justice Bradley delivered the opinion of the court.

"The company having returned the entire balance of their gross earnings over and above current expenses, in the shape of dividends and surplus, for the period in question, and paid the regular tax thereon, we do not see why this was not a full compliance with the law. The object of the law was to impose a tax on net income, or profits, only; and that cannot be regarded as net income, or profits, which is *required and expended to keep the property up in its usual condition proper for operation*. Such expenditure is properly classed with repairs, which are a part of the current expenses. If a railroad company should make a second track when they had but a single track before, this would be a betterment of permanent improvement, and, if paid out of the earnings, would be fairly characterized as 'profits used in construction.' The works of the company would have an additional value to what they had before, with an increased capacity for producing future profits. This kind of expenditure is what Congress meant to reach, when, in the one hundred and twenty-second section re-

ferred to, it imposed a tax not only on the dividends of every railroad, canal, and turnpike company, but also on 'all profits of such company carried to the account of any fund, or used for construction.'

"The counsel for the Government insists that this bridge was a betterment, because it was much more valuable than the old wooden bridge. But the assessor did not include the excess merely: he assessed the whole expenditure bestowed upon the new bridge, without making any allowance for the old one. His idea seems to have been, that all earnings used in new constructions are made taxable by the act, without reference to betterments, or to their being substituted for other constructions. Indeed, his assessment is not for 'profits used in construction,' but for 'earnings used in constructing new Windsor Bridge, \$55,712.60.' In this view he was decidedly wrong. Earnings expended on a new structure may or may not be profits."

In *Barry vs. Mo., K. & T. Ry..Co.*, 27 Fed., 1-5, the definition of net earnings given in *N. P. R. R. vs. U. S.*, 97 U. S., above cited, was followed where a bondholder sought to enjoin the road from appropriating the earnings.

Also, in *So. Pac. vs. Comm'rs*, 78 Fed., 237, 264-5, which was an inquiry into rates.

In *St. John vs. Erie Ry.*, 22 Wall., 136, 149, was involved the question of what were "net earnings" of a railroad as to dividends to be paid to a holder of preferred stock under an agreement that called for a prior payment "of mortgage interest and delayed coupons in full."

"This clause was inserted doubtless out of abundant caution, to prevent the possibility of a claim being set up to the prejudice of the holders of the mortgage securities. Whether the restriction was necessary, for that purpose, we need not consider. The preferred dividends were to be paid out of 'the net earnings of the road.' The lexical definition of *net* is 'clear of all charges and deductions.'—Webster. 'That which remains after the deduction of all charges or outlay, as net profit.'—Worcester, p. 148.

"There is nothing in the agreement or the statute, and we are aware of no legal principle which would authorize the stockholders in question to analyze the business, select out a part of it, and to say that the net earnings specified must be a predicate of that part, and of none other. The company had the right to conduct its operations, in good faith, as it might see fit; and it was from them and all of them that the materials for the computations of earnings were to be derived."

How can the company in the case at bar be allowed to "select out a part" of the cost of production, and say that the earnings "must be a predicate of that part and of none other," any more than was done in the case just cited?

In *Mobile & Ohio R. R. vs. Tenn.*, 153 U. S., 486, 496-7, the question was, What were the net earnings of the road after the payment of 8 per cent dividend to stockholders?

"Again, dividends can be rightfully paid only out of profits. Corporations are liable to be enjoined by shareholders or creditors from making a distribution, in dividends, of capital. Taylor on Corporations, section 565, and authorities cited

"The term 'profits,' out of which dividends alone can properly be declared, denotes what remains after defraying *every expense*, including loans falling due, as well as the interest on such loans. *Correy vs. Londonderry Railway Co.*, 29 Beav., 263.

"The net earnings of corporations out of which profits are distributable in dividends are thus defined in *St. John vs. Erie Railway Co.*, 10 Blatchford, 279: 'Net earnings are properly the gross receipts less the expenses of operating the road to earn such receipts. Interest on debts is paid out of what thus remains—that is, out of the net earnings. Many other liabilities are paid out of the net earnings. When all liabilities are paid, either out of the gross receipts or out of the net earnings, the remainder is the profit of the shareholders, to go toward dividends, which, in that way, are paid out of the net earnings.' This case was affirmed by this court, 22 Wall., 136.

"In *New York, Lake Erie & Western Railroad vs. Nickals*, 119 U. S., 296, 308, the same general rule that shareholders are entitled only to dividends out of the net earnings derived from the operations of the company is reaffirmed."

In *Society for Savings vs. Coite*, 6 Wal., 594, 609, the court examined the question of what were the deposits of a bank for purposes of taxation:

"Deposits are not capital stock in any point of view, and they are not even investments in the sense in which the word is employed in that provision. Where the deposit is general and there is no special agreement proved, it is doubtless true that the title of the money deposited in a bank passes to the bank, and the bank becomes liable to the depositor for the amount as a debt. Regarded entirely as a transaction between the bank and the depositor it would be correct to say that the money deposited became the assets of the bank, and it may also be conceded that all such assets, unless invested in property or securities exempted from taxation, might be required to contribute to the support of the State government as the property of the bank, but it is obvious that the word deposits, as employed in that provision, is not used by the legislature in any such sense."

In *N. Y., etc., R. R. vs. Nickals*, 119 U. S., 296, 308, the court approved its former decision in *St. John vs. Erie Ry.*:

"And that the materials for the computation of its net earnings in any particular year were to be derived from all of its operations, viewing its business as a unit, and not from a part of its operations, or without reference to the necessary and legitimate purposes to which its current receipts might be applied for the benefit of all interested in the property. These principles were again applied in the analogous case of *Warren vs. King*, 108 U. S., 389. See also *Union Pacific Railroad vs. United States*, 99 U. S., 402; *Barnard vs. Vermont and Massachusetts Railroad*, 7 Allen, 512; *Williston vs. Michigan Southern Railroad*, 13 Allen, 400; *Chaffee vs. Rutland Rail-*

road, 55 Vt., 110; Taft *vs.* Hartford, Providence & Fishkill Railroad, 8 R. I., 310; Elkins *vs.* Camden & Atlantic Co., 36 N. J. Eq. (9 Stewart), 233; Lockhart *vs.* Van Alstyne, 31 Mich., 76; Culver *vs.* Reno Real Estate Co., 91 Penn. St., 367."

In *Sioux City & Pac. R. R. vs. U. S.*, 110 U. S., 205, 207, 208, the question was whether the interest to be paid on subsidy bonds received from the United States should be deducted before payment of taxes:

"We think that the judgment was right. The accruing interest on the subsidy bonds loaned by the government to the company, is payable by the company at a future day, to wit, at the maturity of the bonds; and if a sufficient amount of the company's annual net earnings is laid aside (as it should be) to meet that interest when it shall become due, the amount so laid aside would be directly within the scope of the Internal Revenue Act, as it stood when the net earnings in question arose. The 122d section of that act, as amended in 1866, imposed a five per cent tax, not only on all payments of interest due on bonds and on all dividends declared by any railroad or canal company, but also on 'all profits of such company carried to the account of any fund, or used for construction.' The profits here referred to are the profits arising from the operation of the road or canal, without deduction of interest paid to its bondholders or dividends paid to its stockholders, and correspond to the phrase 'net earnings' used in the stipulation of the parties in this case. *Union Pacific Railroad Company vs. United States*, 99 U. S., 402. The expression in the act, 'Profits carried to the account of any fund,' would cover the exact case here if any portion of such net earnings had been carried to a fund created for meeting the interest to be paid on the subsidy bonds.

* * * * *

"Be this, however, as it may, it is clear that where, as in the present case, the interest is to be provided for by a fund, in the nature of a sinking fund, to be laid by for the purpose, the case comes within

the express terms of the internal revenue act; and no deduction of such accruing interest can be made from the taxable net earnings of the company."

What are Gross Earnings?

"Gross" is defined in all the dictionaries, lay and legal, as being the whole or entire. "Having no deduction." 20 Cyc., 1367. "Opposed to net." Webster's International.

Earnings converted into capital cannot be divested of their character as earnings for the purpose of escaping taxation.

Lehigh Co. *vs.* Com., 55 Pa., 448; Taxation on capital stock. The company began business with a capital of \$100,000 which was gradually increased to a million from time to time out of the profits (449).

"To enable it to escape taxation by calling profits capital is mere legerdemain" (451-2).

Pac. Nat. Bk. of Tacoma *vs.* Pierce County, 20 Wash., 657, 682: Taxation upon bank shares. This includes shares of stock held by the bank in other corporations.

Com. *vs.* Hamilton Mfg. Co., 12 Allen, 298; Taxation upon the excess of the market value of all capital stock over the value of the real estate and machinery. The fact that the corporation owns bonds of the United States and that some of the stockholders live in other States, will not exempt it from liability to pay the full tax (Syl.).

Detroit, &c., R. R. Co. *vs.* Com'rs, 119 Mich., 132: Tax upon gross receipts (used synonymously, with gross earnings, p. 134). This includes services for switching, money received for rental of trucks and terminals, interest on loans and deposits, but not to have computed in its mileage tracks over which it ran its trains but belonging to other roads (p. 134).

In Railroad Company *vs.* Railway Company, 44 Ohio State, 287, 315, there was a contract to pay out of "the entire gross earnings and receipts" (p. 290):

"What are gross earnings and receipts? Surely they are not net earnings and receipts. It has been earnestly contended that the word 'receipts' expresses something separate from earnings and was intended to include only the thirty-five percent rents paid under the prior lease. But the parties have not so expressed it in the lease; and on final argument the defendant admitted that as the parties had used the words 'gross earnings and receipts' these words might be taken together as expressing the same thing, unless other parts of the agreement express a different construction" (p. 315).

Clark vs. Vandalia Co., 172 Ind., 409, 418: Question of taxation of railroads on value of corporate property.

"Earnings signify money; net earnings the sum received in excess of operating expenses" (p. 418).

"When surplus earnings are considered by the board to enhance the value of the capital cost of taxation, as they must be, to reassess and retax the same as money on hand or on deposit is doubly taxation pure and simple" (p. 418).

In Com. vs. Penn. Gas Coal Co., 62 Pa. St., 241: Tax on net earnings or income.

"The net earnings or the income are the product of the business deducting the expenses only" (p. 242).

Com. vs. Ocean Oil Company, 59 Pa. (9 P. F. Smith), 61: Tax of three per cent on net earnings or income.

"The question therefore is what is the meaning of 'net earnings or income.' Does it mean as it was considered by the Treasurer in his report to the Auditor General the product of the business after deducting the expenses only (p. 63)?"

"But it is contended by the company that the annual product must first be applied for the redemption of capital and this would leave no net earnings or income to tax. The court below compromised between

these two constructions and held there must be an application of so much of the annual product as would repay the capital in the probable number of years that the oil would flow or be taken from the land and then the surplus would be the net earnings or income subject to taxation (pp. 63 and 64).

"The present company pays dividends which are of course its net earnings or income and it is the net income, whether declared or not, the State intended to tax. This is the plain, common sense meaning of the term made familiar to everyone since the formation of the internal revenue system. The theory of the company is that the capital must be repaid to its stockholders and then it has no capital left" (p. 64).

Com. vs. Pa. Gas Coal Co., 3 Brews. (Pa.), 107: Tax on net earnings or income:

"The court below allowed a taxation of the cost of exhausted land before net earnings were arrived at for taxation (p. 109). This was reversed by the appellate court saying, 'The net earnings or income are the product of the business deducting the expenses only'" (p. 113).

Phil. Contributorship for Ins. vs. Com., 98 Pa., 48: Tax on net earnings or income:

"It is claimed by appellant that the interest on United States bonds and Pennsylvania State bonds which were exempt from taxation and the loss occasioned by the sale of United States bonds at a lower price than paid for them were not a part of net earnings or income. The court held, however, that this was a franchise tax and that the interest was properly included and that any loss on the sale of bonds could not be deducted" (p. 52).

Com. vs. U. S. Express Co., 157 Pa., 579, 584: Tax on gross receipts. Company not entitled to deduct amounts paid other companies for transportation (p. 584).

"The defendant might, with equal propriety, claim the right to deduct office expenses and cost of local delivery" (p. 584).

Com. vs. Phil. and Erie R. R., 164 Pa., 252: Tax on net earnings. Rental paid by the road for equipment and rolling stock is deducted as operating expenses to ascertain net earnings:

"Engines and the freight cars and passenger cars and the necessary supplies are as essential to the running of the road as rails and cross-ties and stations, and the supplies necessary to them. The road could not be run at all without them, and if they have to be hired because the company is unable to own them we cannot understand why the cost of hiring them should not be regarded as part of the operating expenses (p. 260). The net earnings or income are the product of the business deducting expenses only."

State vs. St. Paul vs. Ry., 30 Minn., 311:

"Tax on gross earnings based on receipts on account of the operation of said railroads (p. 312).

"It is clear that these are the only receipts of which any account is to be taken between the company and the State; and, as that account is to be kept and an abstract thereof furnished to the treasurer for the purpose of ascertaining earnings on which the three per cent is to be paid it is equally clear that no other receipts were intended to enter into the compensation or make any part of such earnings" (pp. 312, 313).

State vs. N. Pac. R. R., 32 Minn., 294, 295: Tax on gross earnings:

"Held that these include earnings on leased lands within the State" (p. 300).

Railway vs. Shinn, 52 Ark., 93, 97: Tax on gross earnings of the railroad. Held to include earnings of the transportation of another company operated by it (p. 97).

Smith vs. Bates Machine Company, 182 Ill., 166: Contract to pay money out of earnings. "Earnings does not mean net earnings" (p. 169). "The acceptors were not en-

titled to deduct the expenses of the contract before paying" (p. 170).

State vs. Central Tr. Co., 106 Md., 268: Tax on gross receipts or earnings from all sources within the State (pp. 279-280).

The various items which were held to be included within this term were set out on page 78, as follows:

"1. Earnings from the investment of portions of its capital, surplus, and dividends, in real estate, ground rents and mortgages.

"2. Earnings from some investments in bonds and stocks of other companies.

"3. Profits on dealings in real estate, ground rents and mortgages.

"4. Earnings from loans on collateral securities.

"5. Earnings as trustees under mortgages.

"6. Profits from participation in various underwritings" (p. 278).

Belfast, etc., R. R. vs. Belfast, 77 Me., 452, 455.

A by-law to divide the net earnings semi-annually among stockholders:

"In a general sense net earnings are the gross receipts less the expenses of operating the road to earn such receipts. But several kinds of charges must be first taken out of net earnings before dividends can be declared" (page 452).

"Therefore, if there is a bonded debt the interest on it must be reckoned out of net earnings" (page 452).

"The general practice of railroads has been to include with expenses chargeable to capital those which are incurred in the original construction of the road. The courts have admitted the reasonableness of this rule. The idea is that the capital paid in and the capital borrowed unitedly produce the earnings and that a share of the same should be accorded to each. The distinction between expenses for construction and ordinary expenses is maintained in the leading cases" (page 453).

Citing *Corry vs. Railroad Co.*, 29 Beav., 263; *Bouch vs. R. R.*, L. R., 4 Ex. Div., 133; *Mills vs. Northern R. Co.*, L. R., 5 Ch. App., 621; *Pierce vs. R. R.*, 125.

People vs. Roberts, 52 N. Y. Supp., 859, 860.

Tax upon steam roads based on the gross earnings within the State:

"The franchise of the relator is one for railroad purposes. * * * Some of the stocks and bonds, the income from which has been charged up by the Comptroller as a part of his gross earnings may be stocks and bonds of corporations which are feeders to the railroad and its holding of their stocks and bonds may be for the purpose of controlling such corporations so they shall act in harmony and conjunction with it and the purchase and holding of such securities for such purposes may, perhaps, be said to be incident to its business. If so the receipts derived therefrom are correctly classed as part of its gross earnings as a railroad corporation; but if, on the other hand, they are not held for any such purpose but are investments made from its surplus capital the income, nevertheless, constitutes a part of the earnings of its capital stock and the relator cannot be heard to complain because it was derived from a source and a kind of business it was not authorized to engage in" (page 860).

N. Y. vs. 34th St. Ry., 122 N. Y. Supp., 344, 346. Tax on gross receipts ("gross earnings" also used):

"Wherever the words 'gross receipts' are used they refer to receipts from operation and the words thus used have been considered to mean 'fares'" (page 346).

"Profits" are regarded by some courts as "net earnings."
32 Cyc., 587.

Connolly vs. Davidson, 15 Minn., 519.

By other courts "profits" is regarded as a less comprehensive term than "earnings."

32 Cyc., 588, n. 35.

Wallace *vs.* Penn. Co., 195 Pa., 127, 129, 130.

So, if "profits" * * * denotes what remains after defraying every expense (153 U. S., 497) it follows, *a fortiori*, that what remains in the present case *after* deducting the cost of raw materials is *not* gross earnings.

"When the tax is laid upon or measured by the *gross earnings* of a corporation, this term includes *all income* from its business, but does not include cash received from the sale of property or raw material in which a portion of the capital was invested."

37 Cyc., 1030.

State *vs.* N. W. Tel. Co., 107 Minn., 390.

State *vs.* St. Paul R. R., 30 Minn., 311.

N. Y. *vs.* Fulton St. R. R., 130 N. Y. App. Div., 791.

Com. *vs.* Brush Elec. Lt. Co., 204 Pa., 249.

The "net profits" or "net earnings" from which dividends can be paid are properly the gross receipts less the expenses of carrying on the business of the corporation to earn such receipts.

Van Dyck *vs.* McQuade, 86 N. Y., 47.

Williams *vs.* Western Union, 93 N. Y., 162, 191.

Phillips *vs.* Eastern R. R., 138 Mass., 122.

Park *vs.* Grant Locomotive Works, 40 N. J. Eq., 114, 121.

"Net earnings" are the gross receipts less the current working expenses, not including interest on money borrowed.

Corry *vs.* Londonderry Ry., 29 Beav., 263.

People *vs.* Supervisors, 4 Hill, 20.

"Net earnings" are the gross receipts less the expenditures made in obtaining them, exclusive of the capital invested in construction and outfit.

Colting vs. R. R., 54 Conn., 156, 168.

The case chiefly relied upon by the gas company is the *Brooklyn Gas Company vs. Morgan*, 144 N. Y. App., 266; 99 Supp., 711. In this case the court considered what were the gross earnings of a gas company for the purpose of taxation. The court held that coal and oil used to make gas were not taxable; that these were a part of the gross receipts, not a part of the gross earnings. "Earnings do not include capital, but are the production or outgrowth of capital" (page 267).

The court decided, however, that coal used under the furnace and the labor employed in making gas were properly classed as part of the gross earnings (page 267).

The situation is that a gas company having a capital stock of \$2,600,000, with assets many times that and an annual earning capacity of \$1,500,000, admits that the raw material (see page 3 of the record) is paid for partly out of its earnings, but claims that it is entitled to exemption for all the raw materials because part of it was paid out of the capital. It is difficult to see how, in spite of this statement in the record, any part of the amount so spent for raw materials can be said to be capital.

Respectfully submitted,

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COURT OF APPEALS
DISTRICT OF COLUMBIA
FILED

JAN.-15-1916

IN THE *Henry W. Stoddard*
Plaintiff.

Court of Appeals, District of Columbia.

JANUARY TERM, 1916.

No. 2898.

DISTRICT OF COLUMBIA, APPELLANT,

vs.

WASHINGTON GASLIGHT COMPANY, APPELLEE.

BRIEF FOR APPELLEE.

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IN THE
Court of Appeals, District of Columbia.

JANUARY TERM, 1916.

No. 2898.

DISTRICT OF COLUMBIA, APPELLANT,

vs.

WASHINGTON GASLIGHT COMPANY, APPELLEE.

BRIEF FOR APPELLEE.

This case is an appeal by the District of Columbia from a judgment in the trial court against it and in favor of the appellee for \$31,321.62, with interest thereon from the 15th day of June, 1914, rendered by the court below on overruling the appellant's demurrer to the declaration and the election of the appellant to stand upon such demurrer (Record, p. 7). The action was for the recovery of a tax imposed by the appellant upon the appellee under the Personal Tax Law of the District of Columbia, payment of which was enforced under threats of distraining appellee's

goods and chattels, to prevent which distress and under protest the tax was paid and the action below was to recover the same, after due demand for and refusal of refund of the tax so paid.

The question presented by the declaration was whether the tax was leviable upon \$604,842.20, which had been expended, from appellee's capital, in the purchase of raw materials for the manufacture of its product, and which outlay had been by it credited back to its capital out of its receipts from the sale of the said manufactured product, appellant insisting that the return to its capital of the moneys which had been taken from its capital, for the purchase of the said raw materials, constituted a part of its gross earnings for the tax year in question, namely, the tax year ending June 30, 1913, while appellee contended that its gross earnings were what was left of its gross receipts, less the cost to it of the raw materials from which the product sold by it had been manufactured.

In order to present the case in such manner that the question involved could be determined upon demurrer, without the expense to the parties of a jury trial, the original declaration was amended by adding to it the statement, set forth at page 3 of the record, that "the said sum of \$604,842.20, money so spent for the said raw material purchased as aforesaid, was money taken from its capital, *which capital was composed in part of such part of its earnings theretofore added to its capital as remained to it after providing for the payment of all charges and expenses, including real and personal taxes for and during the year in which said earnings had accrued, and of dividends on its capital stock,*" it being contended by the appellant that if the capital from which the money to buy the raw materials was taken had been composed in any part of earnings during former years, however remote, carried to the surplus or capital of the company, even though such earnings had already paid the personal tax required for the year or years during which

they accrued, they nevertheless remained earnings, and when used for the purchase of raw materials could not be returned to the capital, from which they had been withdrawn for the purpose of the said purchases, out of the sale of the raw material in its manufactured form without again becoming part of the gross earnings of the company and liable again to be taxed as such gross earnings.

The contention last above stated, it is submitted, is sufficiently refuted by any plain statement of it. A further contention on the part of the appellant, we submit, stands upon no higher ground, namely, the contention that if the cost of the raw material which went into the manufactured product may properly be deducted from the gross proceeds of the sale of that product in its manufactured form, in order to determine what the gross earnings are, a similar deduction should be made on account of the cost of labor and appliances used in the manufacture of the raw materials into its manufactured and salable form. The cost of raw materials, though returned to the company in its gross receipts from the sale of those materials in their manufactured form, is simply and only a return to it of its capital, while the cost of the labor of manufacture is an expense incident to the process of turning the raw material into a manufactured product, the return for which in the price realized for that product is recompense for labor, and therefore earnings in the clearest sense of that term.

The law under which the tax was levied is the fifth section of the act approved July 1, 1902 (32 Stats. at Large, p. 617), known as the Personal Tax Law, which provides as follows:

“Par. 5. Each national bank as the trustee for its stockholders, through its president or cashier, and all other incorporated banks, and trust companies, in the District of Columbia, through their presidents or cashiers, and all gas, electric lighting, and telephone companies, through their proper officers, shall make

affidavit to the board of personal tax appraisers on or before the first day of August each year as to the amount of its or their gross earnings for the preceding year ending the thirtieth day of June, and shall pay to the collector of taxes of the District of Columbia per annum on such gross earnings as follows: Each national bank, and all other incorporated banks, and trust companies, respectively, six per centum; each gas company, five per centum; each electric lighting, and telephone company, four per centum. And in addition thereto the real estate owned by each national or other incorporated bank, and each trust, gas, electric lighting and telephone company in the District of Columbia shall be taxed as other real estate in said District: *Provided*, That street railroad companies shall continue to pay the four per centum per annum on their gross receipts and other taxes as provided by existing law, and insurance companies shall continue to pay the one and one-half per centum on premium receipts, as provided by section six hundred and fifty of the Code of the District of Columbia. That so much of the act approved October first, eighteen hundred and ninety, entitled 'An act to provide for the incorporation of trust, loan, mortgage, and certain other corporations within the District of Columbia' as is inconsistent with the provisions of this section is hereby repealed."

This section, curtailed so as to express only its provisions in regard to gas companies, may be summarized as follows:

All gas companies, through their proper officers, shall make affidavit to the board of personal tax appraisers on or before the first day of August each year as to the amount of their gross earnings for the preceding year ending the thirtieth day of June, and shall pay to the collector of taxes for the District of Columbia 5 per centum on such gross earnings, in addition to which the real estate owned by such companies shall be taxed as other real estate in said District.

Section 5 has been quoted in its entirety, however, because it shows that banks, trust companies, gas, electric lighting and telephone companies are taxed, in lieu of a tax on their

personal property, by a specified percentage on their "gross earnings"; that street railroad companies are taxed a specified per centum on their "gross receipts," and that insurance companies are taxed on their "premium receipts." Section 6 of the same act imposes a tax of $1\frac{1}{2}$ per centum upon the "gross receipts" of guaranty and fidelity bonding companies or of individuals engaged in that business; while section 9 imposes a tax of 4 per centum per annum upon the "gross earnings" of building associations.

It is, of course, well established that, even in the re-enactment of one statute in substitution for another, any change in words is construed to intend a change in meaning. *A fortiori*, where different words, such as "gross earnings," "gross receipts," etc., are used in the same act, in the imposition of taxes upon different classes of corporations, a difference in meaning is, likewise, to be intended, in the absence of plain indication to the contrary. Here, the implication from the context supports the *prima facie* principle of construction involved—street railways may well be taxed on their gross receipts, both because the tax is fixed at a lower rate, and because such corporations do not invest capital in the purchase of raw materials for the purpose of manufacture and of sale in an altered state, their gross earnings, except under unusual circumstances and in exceptional cases, being, also, their gross receipts; while a tax upon the gross receipts of a building association would be a tax upon the principal of every loan it collects, and a like tax upon a manufacturing corporation, as in the case of the appellee, would impose a tax upon the gross sales of the manufactured product, which is obviously a very different thing from a tax upon its gross earnings.

The plain difference between gross earnings and gross receipts in cases like the present is apparent from illustrations, which might be multiplied indefinitely. For example, a cotton factory expends a hundred thousand dollars of its capital in the purchase of cotton, which it manufactures into cloth

at a cost of \$75,000, and which it sells, in its manufactured state, for \$225,000. Is the entire \$225,000 "earnings"? On the contrary, is not \$100,000 of this amount merely a return of the capital which it invested in the cotton, in its raw form, to be sold later in its manufactured form? And are not its "gross earnings" the \$75,000 which it receives as compensation for its labor in manufacturing the cotton into cloth and the \$50,000 profit which it realized in the transaction?

Wanamaker's purchases during the year twenty million dollars' worth of goods, incurs an expenditure of five million for store rent, salaries of salesmen, and other expenses in the conduct of its business, and sells the goods for thirty million dollars. Is the entire thirty million "gross earnings"? Or are the earnings, simply, the amount received for the goods over and above the actual cost of them to Wanamaker's?

The Washington Gaslight Company buys a hundred thousand dollars' worth of coal, one-half of which it sells, just as it bought it, to the Georgetown Gaslight Company for \$60,000, and the remaining half it sells, manufactured into the form of gas, for \$75,000. Is the entire \$135,000 "earnings"? Or are not its earnings, simply, the \$10,000 which it realized upon its sale of one moiety of the coal to the Georgetown Gaslight Company and the \$25,000 which it realized out of its manufacture and sale of gas from the remaining moiety of the coal?

The Cases Cited in Appellant's Brief.

Very many authorities have been collected in the brief for the appellant, from the presentation of which as they appear in the brief we beg to say, with the utmost respect and regard for the eminent counsel who prepared it, it is difficult if not impossible to determine whether they are, or are not, at all pertinent to the question presented by this appeal. Both because to do so may lighten the labor of the court, and because, as we conceive, the expenditure of so

much time and labor by counsel of marked and recognized ability has proven unsuccessful, with earnest effort, to find any authorities which to any degree support the appellant's contention that the judgment below was erroneous, must be a demonstration that such authorities do not exist, we venture to append the following examination of the cases cited.

In *Union Pacific R. R. vs. United States*, 99 U. S., 402, and in *United States vs. Kansas Pacific Ry. Co.*, 99 *Ib.*, 455, 459, to quotations from which pages about one-fourth of appellant's brief is devoted, the questions were, simply, whether, under a statute which provided that five per cent of the net earnings of the railroad company should be annually applied to the payment of certain of its bonds, (a) moneys deducted from its earnings by the Government for direct application to payment of its bonds should be included in its earnings, (b) what up-keep and equipment expenses were properly to be deducted from its gross earnings in order to arrive at its net earnings, and (c) whether payment of interest on its bonded indebtedness, which bonded indebtedness the court held to be simply another form of its capital, should be charged to its current expenditures in arriving at its net earnings. Neither these questions nor anything in the opinions bear in any way upon the question involved in this case, namely, whether moneys drawn from the capital for investment in raw material are, when the material manufactured from the raw materials has been sold and the moneys so taken from the capital for their purchase has thus been restored to the capital, gross earnings.

Spreckels Sugar Refining Co. vs. McClain, 192 U. S., 397, cited at page 9 of the opposing brief as a case in which gross receipts and gross earnings were held to be the same, will not be found to sustain that proposition. The tax involved in that case was a tax upon "the gross annual receipts" in excess of \$250,000 of any corporation or company carrying on or doing the business of refining sugar, which tax was held to be an excise tax, and to be applicable to receipts from

certain wharves of the plaintiff used by it in connection with its business, but not applicable to receipts by way of interest on bank deposits or from dividends upon stocks of other corporations which it owned. The question of "earnings," gross, net, or of any other character, was in nowise involved.

In *Grant vs. Hartford & New Haven R. R. Co.*, 93 U. S., 225, the tax was upon "profits used in construction," and the question was whether earnings expended in repairs for keeping the property up to its normal condition were "profits used in construction," in the sense of the act of June 30, 1864, imposing a tax upon profits so used.

Barry vs. M., K. & T. Ry., 27 Fed., 1, 5, simply quotes the definition given by the Supreme Court in *Union Pacific R. R. vs. United States*, 99 U. S., 420: "As a general proposition, net earnings are the excess of the gross earnings over the expenditures defrayed in producing them, aside from, and exclusive of, the expenditure of capital laid out in constructing and equipping the works themselves." The case before the court was that of a railroad company, whose expenses, exclusive of its capital laid out in constructing and equipping its works, were merely its operating expenses, including no such items as we are here dealing with, namely, capital expended in raw material for the purpose of being converted for purposes of sale into a manufactured product. Equally irrelevant, and for the like reasons, is *Southern Pacific R. R. vs. Commissioners*, 78 Fed., 237, 264-5.

In *St. John vs. Erie Ry. Co.*, 22 Wall., 136, 149, a railroad company became insolvent and was reorganized under a foreclosure sale, in which reorganization unsecured creditors of the old company were made preferred stockholders, with a provision that the preferred stock should "be entitled to preferred dividends out of the net earnings of said road (if earned in the current year, but not otherwise) not to exceed seven per cent in any one year, payable semi-annually *after payment of mortgage interest and delayed coupons in*

full." The new company leased other roads, borrowed large sums of money, and reached a condition under which its earnings were insufficient to more than pay interest on its indebtedness other than its stock, the rental of the leased roads, and interest on the new moneys borrowed; whereupon one of the preferred stockholders filed a bill for application of the earnings of the company, after paying the mortgage interest and delayed coupons existing at the time of the reorganization to the preferred stock and in priority to the subsequent debts of the corporation as the lessee of the other roads leased and as borrower of the subsequent sums of money. The court held, simply and only, that the words in the reorganization contract with reference to the preferred stock, "*after payment of mortgage interest and delayed coupons in full,*" was controlled by the previous word "*net*" in the same clause of the reorganization contract, which meant "that which remained as net profit after the deduction of *all* charges or outlays," and dismissed the bill. How entirely remote and foreign this citation is to the case before the court the mere statement of the case makes obvious. The right claimed by the stockholders and denied by the court, "to select out a part" of the company's debts and to see that the net earnings specified must be a predicate of that part and none other, was a right to select the mortgages and delayed coupons due at the time of the reorganization, and to apply the net earnings to them only before paying dividends upon the preferred stock—a claim to which there is nothing analogous in the case before the court. *Mobile & Ohio R. R. Co. vs. Tennessee*, 153 U. S., 486, 496-7, is equally without pertinence, as is *Society for Savings vs. Coite*, 6 Wall., 594, 609, which presented only the questions whether the tax imposed on the total deposits of the plaintiff was a tax on property or a franchise tax, and whether the interest received by it on securities of the United States, declared by Congress to be exempt from taxation, was taxable.

In *New York R. R. vs. Nickals*, 119 U. S., 296, the ques-

tion was whether the directors of a railroad company could be restrained from applying, in the exercise of their discretion, the net earnings of the road to betterments rather than to dividends upon the company's preferred stock, while in *Sioux City & Pacific R. R. Co. vs. United States*, 110 U. S., 205, the only question was whether, in a suit to collect an internal-revenue tax on the undivided net earnings of the road, carried to a fund or construction account, the plaintiff was entitled to have the interest upon its bonds deducted from its net earnings before settling the amount to be subject to tax—the court in *Union Pacific R. R. vs. United States*, 99 U. S., 402, referred to in the opinion in the case now under consideration, having already determined, as above quoted, that the bonded debt was “but another form of capital, analogous to preferred stock, and the interest accruing thereon is in the nature of a dividend on such capital. It has nothing to do with, and cannot affect, the amount of the net earnings of the road.”

The State Decisions Quoted.

Turning to the decisions in the State courts cited in the opposing brief, they will be found equally without application to the question presented by the present appeal.

In *Lehigh Co. vs. Commonwealth*, 55 Pa. St., 448, the statute charged a tax, in the case of corporations on which a dividend or profit had been declared of six per cent or more, of half a mill on each one per cent of such dividend or profit. The appellant, besides paying six per cent to its shareholders, had added from its net earnings \$900,000 to its original capital of \$100,000, and the question was whether this increase was not a “dividend or *profit* in the sense of the statute,” this being the only question presented or decided. The case does not refer, even *obiter*, to what the term “gross earnings” means or what it comprises.

In *Pac. Nat. Bank vs. Pierce County*, 20 Wash., 675, 682, the plaintiff in error contended that so much of its assets

as consisted of the capital stock of other corporations in which it had invested its funds could not be taxed, because those corporations, being of the same State with the plaintiff in error, were themselves taxed, and that therefore such taxation would be double and unequal taxation. No question of earnings, gross or net, was involved. Equally remote, foreign and without relevance, is *Commonwealth vs. Hamilton Mfg. Co.*, 12 Allen, 298.

In *Detroit, etc., R. R. vs. Commissioner*, 119 Mich., 132, the tax imposed was upon the gross income of the plaintiff, and the question was whether income from switching, the rental of tracks and terminals and interest on loans and deposits were taxable as such gross income.

R. R. Co. vs. Ry. Co., 44 Ohio St., 287, 315, presented simply the question of the construction of the words "total gross earnings and receipts" in a contract between the parties, the appellant conceding at the argument that the parties had used those words in their contract in such a way that they might be taken together to express the same thing. There is nothing either in the facts of that case, in the questions presented or decided, or in the language of the court which in any manner enlightens or refers to the points in issue here.

In *Clark vs. Vandalia R. R. Co.*, 172 Ind., 409, 418, the only question was whether certain moneys belonging to the defendant were taxable under a statute which authorized assessment for taxation of the property of railroads "under two heads, namely, 'railroad track' and 'rolling stock.'" The only reference to "earnings" in connection with the case was the fact that the moneys in question came to the defendant under a contract of lease with certain other railroad companies under which it was to be paid 25 per cent of their gross earnings. The point decided was that under the statute money of railroads was not taxable except in so far as it affected the value of the capital stock as a whole, and therefore was not taxable in different counties.

In *Commonwealth vs. Ocean Oil Co.*, 59 Pa. St., 61, the tax was imposed upon the net income. The defendant in effect contended that its capital was one million dollars; that its dividends had been some six hundred thousand or more, but that there had been no net earnings because, in view of the probability that the oil supply of their land might be exhausted, there would be no net earnings until they had repaid the full amount of the capital. Some of their shares were sold at \$4 and some at \$20 per share. The trial court had instructed the jury to act on "reasonable probabilities"; to take into account the time it would probably take to exhaust the capital and the profits which would be made in the meantime, and then to consider whether the whole sum returned was net income or earnings or whether one-half, one-third, one-fourth, or some other quantity thereof should be treated as net earnings and taxed accordingly. The company, as the Supreme Court in its opinion states, had paid to the shareholders the income from its works, after deducting all expenses, "as dividends," which payments "were no doubt advertised as such, thus enhancing largely the value of the stock in the market. When the capital stock is created and paid into a corporation authorized to transact any business, whether banking, manufacturing, or mining, and is divided into shares of a fixed amount, that capital is presumed to remain until its dissolution. The value of the stock and the shares into which it is divided may rise or fall according to the success of the enterprise. In banks, for instance, the profits may be largely remunerative, or, if unfortunate, the capital may be utterly lost. This is the theory of incorporated companies; the capital remains either really or nominally until their close. The present company pays dividends which are, of course, its net earnings or income, and it is the net income, whether they declare it or not, which the State intended to tax. This is the plain common-sense meaning of the term, made familiar to everyone since the formation of the internal revenue system. The

theory of the company is that the capital must be repaid to its shareholders and then it has no capital left. But if this company has paid \$600,000, it must be different from all other such companies if its shareholders have not been overpaid already. The court below were, therefore, in error in allowing a portion of the net earnings to be applied to the reduction of the capital stock."

In *Commonwealth vs. Penn Gas Coal Co.*, 62 Pa. St., 241, the preceding case was simply followed, the court adding:

"All capitals of mining companies, whether of coal, iron, copper, or tin, or silver or gold, and so of quarrying companies, whether of stone, marble or slate, are nominal, like those of petroleum companies, and fixed by their promoters at such large figures that, by applying the principles contended for by appellees, the whole annual income would have to be retained to supply the loss of capital, which would disappoint the stockholders of their dividends and the State of her taxes. The difficulties pointed out in our former opinion of adopting and applying any such principle toward these companies, make it necessary to establish one general invariable rule—that the net earnings or net income are the product of the business, deducting expenses only."

Commonwealth vs. Penn Gas Coal Co., 3 Brews., 107, is, also, decided upon the authority of *Commonwealth vs. Ocean Oil Co.*, the opinion of the court being practically a reproduction of its above-quoted opinion in *Commonwealth vs. Penn Coal Gas Co.*, 62 Pa. St., 241.

These authorities have been quoted from at such length because they are the only citations in appellant's brief which in any manner present a contention as to the question whether capital can in any case be treated as earnings. In them, it will be noted, first, that the contention was a right to return the capital of the company to its shareholders, either wholly or in part, before treating the net receipts of the business as income; and, secondly, that this contention

was unaccompanied by any showing what the original capital which the shareholders put into the business was, the claim being the right to return to them the full par value of their stock, for which some of them had paid only \$4 per share, before recognizing any liability to the State for taxes upon net income. In the present case, the claim is, not that the capital or any part of it shall be returned to the shareholders, but simply that capital used to purchase raw materials shall be restored to the capital from the receipts realized from sale of those raw materials in their manufactured state, as being no part of the earnings of the company. What remained of the proceeds of the sale of the manufactured product, after restoring to the capital simply that part of it which had been drawn upon to buy the raw materials, was returned by the company for purposes of taxation as gross earnings, and were assessed and the tax paid accordingly, without dispute or contention. It is obvious, we submit, that neither the facts of these Pennsylvania cases, nor the principles upon which they were decided, are applicable to the present case.

In *Commonwealth vs. United States Express Co.*, 157 Pa. St., 579, the decision was that an express company, upon which the statute imposed a tax upon its gross receipts, could not employ railroads or other common carriers to carry in part its express matter and deduct from its gross receipts for purposes of taxation the amount paid by it for this service, the court holding that the defendants might "with almost equal propriety claim the right to deduct office expenses and cost of local delivery service." The case of *R. R. Co. vs. Commonwealth*, 104 Pa. St., 86, is referred to in the opinion as a case in which the term "gross receipts" had been regarded as equivalent to "gross increase" or "gross earnings"; but that this was an inadvertence upon the part of the court in its opinion will be apparent upon reference to the case cited; and, as shown elsewhere in this brief, railroad corporations, which do not buy raw materials for the purpose

of converting them into a manufactured, salable product, whose only outlays are their operating expenses, and whose only receipts are their compensation for a service performed through such operation, may well have their gross receipts defined as gross earnings. They furnish no analogy to the case of manufacturing, mercantile or other corporations which do buy commodities, either in their raw or their manufactured state, for resale, and whose gross receipts upon such resale comprise both their outlays in the purchase of those materials and their earnings, the latter of which can be ascertained only by deducting from the gross receipts, and restoring to the capital, the outlays in question.

Philadelphia Contributorship vs. Commonwealth, 98 Pa. St., 48, is still further remote from the case at bar, being a case in which the statute made the net earnings of a corporation the measure of its franchise tax. The plaintiff's contention was that income from United States and Pennsylvania State bonds, which bonds were not taxable, should not be included in its net earnings and that the difference between the price paid for United States bonds and their par value should be regarded as a loss and deducted from the gross receipts. *Held*, that the tax in question was not laid on the bonds; that the net income or earnings was merely the measure fixed by the statute of the amount of the franchise tax; that the difference between the par value and the price paid for the bonds could not in any proper sense be regarded as a loss, and that, if it were, a decrease of capital did not necessarily diminish the annual net earnings, the latter being the just measure of the tax imposed on the franchise which had been adopted by the State.

In *Commonwealth vs. Railroad*, 164 Pa. St., 252, the tax was upon the net earnings: the defendant contended that from its gross earnings should be deducted not only its operating expenses, but a rental paid by it for part of its equipment. The judgment below was reversed because this rental was not allowed as a proper operating expense and deducted

from the gross receipts in order to ascertain the net earnings. The relevancy of the citation to the case at bar is not apparent.

The Minnesota citations are no more helpful, from the standpoint of the appellant. The first of them, *Minnesota vs. St. Paul, Minneapolis & Manitoba Ry.*, 30 Minn., 311, holds that a rental paid by one railroad to another for the right to use a portion of its lines was not "gross earnings," and was held not to be so—"rent or compensation paid to the company for the right to operate the railroad cannot be called receipts on account of the operation of it. The company may not operate its railroad at all, but lease it for a gross sum, in which case all receipts on account of the operation of the railroad will go into the hands of the lessee, and the rent only (which would probably be regulated by the expectancy of net earnings) into the hands of the company;" while the other Minnesota case, namely, *State vs. Northern Pacific R. R. Co.*, 32 Minn., 294, holds conversely that the receipts of the renting road, over the lines the right to use which it has leased, are its gross earnings, for which it is liable to taxation.

The first of these cases furnishes the limitation upon the rule, laid down in general terms by some of the authorities, that the gross receipts of railroads are their gross earnings, namely, the limitation that where those receipts are from any source other than compensation for the service rendered by the mere operation of its lines, *i. e.*, other than its fares, they are not gross earnings or earnings at all. *A fortiori*, should a railroad corporation buy coal, oil, or any other commodity, and sell it again, the proceeds of such resale, at least to the extent of the price it paid for the article sold, can in no possible sense be regarded as earnings, gross or otherwise?

At page 18 of appellant's brief *State vs. Central Trust Co.*, 106 Md., 268, is cited as authority for the proposition that among the items properly included within the term gross

earnings were "profits on dealings in real estate, ground rents and mortgages." Appellant's contention in the present case, if maintained, would render, not the profits on dealings in real estate, but the gross proceeds of the sale of real estate, purchased by the defendant for the purpose of resale, gross earnings, and subject as such to taxation. Nothing else pertinent to the present case is contained in the citation.

In *People vs. Roberts*, 52 N. Y. Supp., 859, the tax was a franchise tax, namely, an annual excise tax or license fee which shall be equal to five-tenths of one per centum upon its gross earnings within the State, which shall include its gross earnings from its transportation or transmission business originating and terminating within this State, but shall not include earnings derived from business of an interstate character." The only question in the case was whether the clause "which shall include its gross earnings from its transportation or transmission business originating and terminating within this State" excluded earnings in the State from any other source, and it was held not to do so, the court saying: "The language used is not that of exclusion, but, taking it all together shows the plain intent of the legislature to include earnings of every kind except those arising from interstate commerce. By 'gross earnings,' it seems to me that the statute means all receipts arising from or growing out of the employment of its capital, whether that capital is employed in the transportation or transmission business or otherwise"—the only "receipts" in the case, other than earnings from its transportation or transmission business, being the dividends upon certain stocks and bonds of corporations which were feeders of its business in which it had invested part of its capital, which receipts the court declared to be "correctly classed as part of its gross earnings as a railroad corporation." Had the defendant sold these stocks and bonds, and had the court ruled that the total proceeds of their sale, regardless of their cost to the defendant, had

been "gross earnings," the citation would have possessed pertinency. All the proceeds of the sale of the manufactured product, in the case at bar, without deduction for any part of the cost of its manufacture, were conceded by the appellee to be gross earnings and were by it voluntarily returned for taxation.

City of New York vs. 34th Street Ry. Co., 122 N. Y. Supp., 344, holds that, under a statute imposing a three per cent gross earnings tax upon a railroad company, the term "gross earnings" means gross receipts derived from fares, and is not applicable to rentals received by one railroad company of its lines for the use of another railroad company; the case being identical in principle and decision with *Minnesota vs. St. Paul, etc., Ry.*, 30 Minn., 311, cited *supra*.

The nearest approach to pertinency here of *Wallace vs. R. R. Co.*, 195 Pa. St., 127, cited at page 20 of appellant's brief, is the following:

"Profits derived from capital invested in business cannot be considered as earnings, but in many cases profits derived from the management of a business may properly be considered as measuring earning capacity. This is especially true where the business requires and receives the personal attention and labor of the owner."

In *Commonwealth vs. Brush Electric Light Co.*, 204 Pa. St., 249, the question was whether, under a statute levying a tax of eight mills per annum against electric light companies "upon the gross receipts from their business," the defendant was taxable on its receipts from any other source than electric lighting, its receipts, otherwise, comprising repayment of loans to other companies, sales of electric supplies, interest on its bank balances and the like. It does not appear from the report whether the item "sale of electric supplies such as lamps, drop lights, scrap iron, etc.," was the profit realized from that branch of the business or the total proceeds from such sales without deduction of the cost of the

articles sold, the item, however, amounting only to about \$7,500. That case, however, provided a tax, not upon gross earnings, but upon "the gross *receipts* from their business," requiring a begging of the entire question in this case to render the citation in any way or to any extent pertinent.

With the proposition laid down at page 20 of appellant's brief that "when the tax is laid upon or measured by the gross earnings of a corporation, this term includes all income from its business, but does not include cash received from the sale of property or raw material in which a portion of the capital was invested," we are in entire accord, as is the judgment appealed from.

People vs. Supervisors, 4 Hill, 20, cited at page 20 of appellant's brief, defines "income" as "that which is received from any business or investment of capital, without reference to outgoing expenditures," and "profits" as, generally, "the gain made upon any business or investment when both receipts and payments are taken into the account." Neither the statute, the facts of the case or the language of the opinion refer in any manner to "earnings," either gross or otherwise.

Railway vs. Shinn, 52 Ark., 93; *Smith vs. Bates Machine Co.*, 182 Ill., 166; *Belfast R. R. Co. vs. Belfast*, 77 Me., 445; *Connolly vs. Davidson*, 15 Minn., 519; *City of New York vs. Fulton St. R. R. Co.*, 130 N. Y. App. Div., 791; *Van Dyck vs. McQuade*, 86 N. Y., 47; *Williams vs. Western Union Telegraph Co.*, 93 N. Y., 162; *Phillips vs. Eastern R. R. Co.*, 138 Mass., 122; *Park vs. Grant Locomotive Works*, 40 N. J. Eq., 114, 121; *Corry vs. Londonderry Ry. Co.*, 29 Beav., 263, and *Cotting vs. N. Y. & New Eng. R. R. Co.*, 54 Conn., 156, are so obviously without analogy or relevance to the case at bar as to render discussion of them unnecessary.

A case in all respects in point with the case at bar, we submit, is the case of *People ex Rel. Union Gas Co. vs.*

Morgan, 114 App. Div. (N. Y.), 266, the facts of which case and the principles governing it are thus cited in the opinion of the court:

"The relator is required by section 186 of the Tax Law (Laws 1896, p. 858, c. 908) to 'pay to the State for the privilege of exercising its corporate franchises or carrying on its business in such corporate or organized capacity in this State an annual tax which shall be five-tenths of one per centum upon its gross earnings from all sources within this State.' The gross receipts of the relator for the year ending October 31, 1898, were \$3,805,626.15, and on this amount the comptroller fixed the tax under the statute above referred to at five-tenths of one per cent., amounting to \$19,028.13. The relator is engaged in the business of manufacturing and selling gas. For the production of such gas it purchases from time to time raw material consisting principally of coal and oil which it transformed into the manufactured product. It appeared before the comptroller that at all times during the year ending October 31, 1898, a portion of the capital of the company was invested in such raw material, which from time to time was converted into the manufactured product and came back to the relator as cash, being part of the price of gas sold to the consumers. During the year in question the relator thus expended for raw material \$947,546.28 which material was made into gas and sold to the consumers and is included in the gross receipts of the company of \$3,805,626.15 as above stated.

"The comptroller has thus fixed the tax not on the 'gross earnings' of the relator, as required by the statute, but on its gross receipts. Capital of a corporation which must first be invested before it begins to earn anything cannot be said to be a part of the earnings of such corporation merely because it is turned into cash, and thus in one sense becomes a receipt of the corporation. Earnings do not include capital, but are the productions or outgrowth of capital. In some cases like the one now under consideration the capital must be supplemented by labor, and such other expenditures as may be incidental to the development

of the manufactured product from the raw material. Such incidental expenditures are doubtless part of the 'gross earnings.' If the coal in question had been used under the boilers for developing heat, such coal like labor would be merely an incidental expenditure in the process of converting the capital from one form into another, and should probably be included as a part of the 'gross earnings' of the relator. But the evidence is that the coal in question was not used for generating heat, but was of a different kind and was converted into gas.

"In fixing the 'gross earnings' of the relator there should therefore have been deducted from the gross receipts the cost of the raw material, which amounted to the said sum of \$947,546.28. The relator claims that other deductions should have been made. Perhaps this is so as to some of the claims thus made, but the evidence before the comptroller was insufficient to form a proper basis for reduction. The entire proceeding should therefore be remitted to the comptroller for a rehearing."

It is respectfully submitted that there is no error in the judgment below and that it should be affirmed.

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